

Treasury's Proposal Mandating Clearing of "Standardized" Swaps

A key component of Treasury's proposal for OTC swaps is its requirement that "standardized" swaps be cleared. The proposal does not define the term "standardized." Instead, it would require that, within six months of the proposal's enactment, the SEC and CFTC jointly define "as broadly as possible" what constitutes a "standardized" swap. Additionally, the proposal provides that acceptance of a product by a clearinghouse would create a "presumption" that the relevant product is "standardized."

While there is a consensus in support of many aspects of Treasury's proposal, its provisions regarding contract standardization and mandatory clearing raise key issues that need to be considered:

- The definition of what constitutes a standardized trade is not clear;
- Not all privately negotiated derivatives trades can or should be standardized;
- Not all standardized derivatives trades can be cleared;
- Mandating that all standardized trades be cleared may increase rather than decrease risk.

What is a "standardized contract"?

Traditionally, the term "standardized contract" referred to listed, exchange-traded contracts. The trading of standardized contracts on an exchange requires participating parties to specify uniform "economic terms" for a particular transaction, including, but not limited to:

- what asset is to be bought or sold,
- amount to be delivered,
- delivery date,
- delivery location (in the case of physically settled commodities contracts), and
- contract maturity date and length.

The only term negotiated between the parties to the contract is the price to be paid on delivery.

Example: The Chicago Mercantile Exchange (CME) wheat futures contract specifies delivery of a particular grade of wheat.

- No. 2 Soft Red Winter
- Delivery of 5,000 bushels
- Delivery must take place by the second business day following the last trading day of the delivery month, which can be March, May, July, September or December
- A limited number of delivery locations

- Contract maturity dates fall on the business day prior to the 15th calendar day of the contract month and contracts typically date only two to three years into the future

Contract standardization facilitates trading and price discovery by limiting the type of contracts traded, thereby concentrating trading on just a few types of contracts. When cleared by a central counterparty, or clearinghouse, a standardized contract becomes *fungible*: that is, any contract traded can be used to offset an obligation with a clearinghouse against any other contract of the same type and specifications. This means that a trader who wants to exit a position need not deal with the same counterparty with whom the position was established: the trader can enter into an offsetting contract with any other trader who clears through the same clearinghouse.

Together, contract standardization and the *fungibility* created by the clearinghouse guarantee facilitates trading and price discovery.

What is a "customized contract"?

A customized derivative contract (also called a privately negotiated or OTC derivative contract) is one that is negotiated between two counterparties. It enables the counterparties to custom-tailor the terms of the contract to address their particular risk profiles and needs. The privately negotiated derivatives business has grown because standardized contracts are only of limited use in hedging. They are of limited use because they do not contemplate the specific terms of their underlying contracts or the specific risks of the industry in which the company operates. Some of the specific terms include maturity dates, the number of days used to calculate interest, payment dates and frequency and the benchmark rate against which the company seeks to hedge. The specific risks of industries can be numerous and only accurately determined by the companies within those industries. Further, because standardized contracts do not allow companies to exactly match the underlying hedged exposure, they do not qualify for favorable hedge accounting treatment. Therefore, product uniformity is not beneficial to American companies when they have risks unique to their contracts or businesses and need customized risk management tools to mitigate these risks.

- A cereal manufacturer wishing to buy a contract for future delivery of 2,000 bushels of wheat for delivery in January at a location other than that specified by the futures exchange cannot use a standardized contract.

Initiatives that would seek to standardize the terms of all OTC swaps are counterproductive since these initiatives can lead to ineffective hedging and incomplete transfer of risk, leaving end users with unwanted and unmanageable basis risks¹ they don't want and can not manage effectively.

¹ Basis Risk is generally defined as the risk that offsetting investments in a hedging strategy will not be affected by price changes in entirely opposite directions from each other. This imperfect correlation between the two investments creates the potential for excess gains or losses in a hedging strategy.

Clearing and standardization

"Standardized" trades are not automatically clearable. While standardized economic terms are a necessary step for clearing, they alone are not sufficient to consider a swap clearable.

The proposal's clearing mandate, as written, presents concerns because it presupposes that standardization automatically enables clearing without allowing for consideration of additional factors. Additional factors that should be considered include the frequency with which the contract is traded and the volume of the transactions in the contract, whether there is sufficient liquidity to provide reliable price discovery, whether any differences in the terms of the contract compared to the terms in standardized contracts are of economic significance and the extent to which any of the terms in the contract are disseminated to third parties. The focus on mandating central clearing to address counterparty credit risk may actually increase overall risk as market participants seeking to mitigate specific commercial risks would find it harder to enter into the kind of tailor-made OTC transactions capable of mitigating such risks.

For example, reducing counterparty credit risk for a product or asset class through clearing may be of little value while having the flexibility to customize tailored solutions for commercial risk may be of vital importance. The marginal value gained by reducing counterparty credit risk through clearing would be eclipsed by the increase in commercial risk that end users would bear either as a result of increased basis risk by being forced to hedge with a standardized product or by not hedging altogether.

Asset classes are unique; factors that may imply central clearing is appropriate for one asset class may not be present for another.

- The primary goal of central clearing is to mitigate bilateral counterparty credit risk between clearing members by mutualizing the risk among the clearing members. However, market participants vary among asset classes. While trading between dealers or between dealers and systemically significant institutions may constitute the bulk of activity in a certain asset class, another asset class may be dominated by trading with retail customers or corporations. The counterparty credit risk posed by the former is typically higher than for the latter. Therefore, clearing in the former market is desirable where possible (and, in fact, there are numerous examples of market-led initiatives to clear in those markets²) while clearing in the latter market will provide minimal benefit in terms of counterparty credit risk mitigation but will certainly add costs.
- Similarly, other important characteristics limit the benefits of clearing. Asset classes or products that provide continuous pay-out structures, objective market prices for risk valuation purposes,

² ISDA and 15 large derivatives dealers publicly committed in a letter to the Federal Reserve Bank of New York that the firms would submit 95% of new eligible credit default swap trades for clearing by October 2009. A copy of the letter may be found at: <http://www.newyorkfed.org/newsevents/news/markets/2009/ma090908c.pdf>.

and strong, stress-tested risk management infrastructures are less susceptible to counterparty credit risk and thus would benefit significantly less from clearing.

Focusing primarily on reducing counterparty credit risk in a drive toward standardized contracts for the purpose of central clearing could:

- actually increase risk, as market participants seeking to mitigate specific commercial risks would find it harder to enter into the kind of tailor-made OTC transactions capable of mitigating such specific commercial risks;
- provoke a risk-enhancing, unhealthy trade-off between reducing credit risk in certain standardized contracts and increasing basis risk by encouraging the use of those standardized contracts to cover underlying risks, on a mismatched basis;
- discourage dealers from offering those kinds of customized contracts and/or increase their cost where available;
- require end user, corporate firms to allocate increased amounts of money and margin at clearing houses and so increase the cost of managing risk;
- simply replace credit risk with liquidity risk.
 - Daily margining, would not only create considerable administrative challenges (daily mark-to-market valuation and daily margining; collateral in cash not in assets), but also force the use of valuable credit lines to draw down cash needed. Systemically, risk would not have been reduced: instead of a credit exposure to a swap, the banking sector would be left with credit exposure on a loan.

The proposal also provides that acceptance of a product by a clearinghouse for clearing would create a “presumption” that the relevant product is “standardized”. This provision carries potential unintended consequences. It could lead to a concentration of clearing volume in the very first clearinghouse to offer clearing for a product, without regard to whether that solution is the most appropriate or desirable, whether the product has matured sufficiently that it is ready to become the *de facto* market trading standard, or whether the clearinghouse has the wherewithal, credit infrastructure, resources and capacity to clear the entire market for a given product.

Mandating clearing almost exclusively on whether a swap contains standardized economic terms fails to consider whether such clearing achieves a real reduction in risk. Ultimately, it is not clear that the incremental benefits derived from mandatory clearing of standardized swaps, where the term "standardized" is based primarily on whether such swap contains standardized economic terms without reference to the important additional considerations highlighted above, offset the costs and risks associated with mandatory clearing.